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Greenbury Report (UK)

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Synonyms

Director Remuneration; Remuneration Report

Definition/Description

The *Greenbury Report on Directors Remuneration* (1995) (hereafter called the *Greenbury Report*) was one of the first comprehensive governance codes directly addressing executive and director remuneration. The *Greenbury Report* was commissioned by the Confederation of British Industry in response to public concerns over recently privatized public utilities and the salaries and bonuses earned by executives, while they implemented job cuts, and service price increases. The *Greenbury Report* recommended an independent remuneration committee, linking executive pay to corporate financial and operational performance measures, and increased the requirements for disclosure and transparency on directors' remuneration. However, the credibility of the *Greenbury Report* was challenged due to the composition of the group; it was not deemed to be independent of the sector it was to investigate, and it was argued that its recommendations did not go far enough.

The financial crisis of 2008 highlighted the failure of the *Greenbury Report's* recommendations for limiting excessive executive pay. In particular, the *Walker Review of the Banking Sector* found that performance-based bonus schemes in banking corporations that are supposed to align executive objectives with shareholder objectives increased corporate risk in the period leading up to the financial crisis. In addition, during the crisis, executive pay in large publicly listed corporations (PLCs) continued to increase, while workers' wages stagnated. Therefore, despite Greenbury's recommendations, executive pay continued, and still continues, to be a concern for the public and policymakers alike. Nonetheless, improved transparency on remuneration and a greater linking of pay to performance followed from the *Greenbury Report* and most corporations now include operational measures linked to performance and sustainability.

Introduction: The Problem of Excessive Executive Pay

Corporate governance mechanisms are traditionally seen as devices for reducing agency costs between shareholders and managers. These costs arise from mismatched incentives, information

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asymmetry, and a belief that executives are self-serving at the expense of shareholders. However, the role of governance is changing. Regulators and governments are increasingly employing governance tools that impose public responsibilities on corporations, including measures that seek to equalize wealth distribution, promote workforce diversity and equality, and pursue environmental objectives (Choudhury and Petrin 2018). The result of this is that executive pay, particularly in PLCs, is deemed to be of interest to a society at large as the public, either directly through individual shareholdings or indirectly via institutional investors such as pension schemes, invested in them. Therefore, stakeholder theory argues that the public's interests should be protected by the board and not sacrificed for executive rewards. The public is interested in the sustainability of corporations, as this ensures economic stability, a strong financial sector, and employment. Recent corporate failures have increased the public's concern about financial performance-based pay packages that incentivize excessive risk-taking. Further public concerns have also arisen due to actions taken by corporations in response to the financial crisis. For example, many corporations implemented freezes on workers' wages and started to employ workers on a casual basis, using zero-hour contracts. The growth of these contracts have raised broader societal issues of distributive justice and fairness (Villiers 2010), particularly as these austerity measures were not typically applied to executive pay packages.

Background to the Greenbury Report

The *Cadbury Report* on *Financial Aspects of Corporate Governance (1992)* included recommendations on executive pay and the establishment of a remuneration board subcommittee. Within 2 years of the *Cadbury Report*, excessive executive pay again became a hot issue as politicians highlighted recent utility privatizations that created 50 millionaires among the executives. A key media focus was the 75% pay increase for the chairman of British Gas, Cedric Brown, which resonated with a society suffering from high unemployment, resulting in demonstrations from the public and small shareholders at the corporation's annual general meeting (Jones and Pollitt 2002). The issue was highly embarrassing to a government that made utility privatization one of its key policy objectives. The government approached the Confederation of British Industry to investigate the matter. It subsequently appointed Sir Richard Greenbury, Chairperson and CEO of Marks and Spencer, to investigate and produce a report and recommendations.

The terms of reference of the *Study Group on Directors' Remuneration* (hereafter called the "Group") were "to identify good practice in determining directors' remuneration and prepare a code of such practice for use by UK PLCs" (Greenbury 1995, p. 9). Directors and boards of large PLCs were the focus of the Group though the *Greenbury Report* highlighted that the principles also applied to smaller listed corporations and to other senior executives. The aim of the Group was not necessarily to reduce executive pay, rather to provide a means of establishing a balance between executives' pay and their performance and enhancing accountability and transparency on executives' pay. The final *Greenbury Report* was produced in 1995 and focused on providing recommendations in four main areas, including:

- Remuneration committees
- Remuneration policy for executive and non-executive directors
- Service contracts and compensation on termination
- Disclosure

These are now discussed in turn.

Remuneration Committees

The *Greenbury Report* recommends all PLCs establish a remuneration committee as a subcommittee of the board and that it be assigned full responsibility for all matters relating to executive pay. Where this is not done, the board must explain why and outline the alternative arrangements which have been put in place in the annual report. The intention for the creation of remuneration committees was to prevent executives from designing their own pay packages.

The *Greenbury Report* recommends that the remuneration committee: has a clearly defined terms of reference that ensures there is a corporation-wide policy on remuneration; determines individual remuneration packages for each executive; and reports directly to shareholders on all matters relating to executive remuneration. The *Greenbury Report* recommends that membership of the remuneration committee should comprise only non-executive directors as they have no direct personal financial interest in executive remuneration. In addition, membership is not to include directors with other executive directorships, as this could result in the bidding up of one another's remuneration. The remuneration committee members are to have a good knowledge of the corporate and its executive directors and a full understanding of shareholder concerns. As a result, Greenbury rejected proposals that the remuneration committee include independent members from outside of the corporation as they would lack the recommended level of knowledge. However, this was deemed to be a weakness as a way around this could have been included, such as ensuring that appropriate training or access to relevant expert advice is provided to the remuneration committee. The *Greenbury Report* recommends that a minimum of three directors make up membership of the remuneration committee in large corporations. Finally, the report recommends that the fees of non-executive directors, some of whom will be members of the remuneration committee, are determined by the whole board.

Remuneration Policy

The underlying basis for the remuneration policy outlined in the *Greenbury Report* is that executive remuneration should be sufficient to attract and retain the appropriate executive talent though avoiding paying more than is necessary for this purpose. To determine the appropriate remuneration, the *Greenbury Report* recommends the remuneration committee identify an appropriate comparator group of corporations and investigate how performance and remuneration are linked in those corporations and how pay is divided between the various fixed elements, such as basic salary, benefits in kind, and variable elements, such as annual bonus and long-term incentives. The *Greenbury Report* identifies a role for both annual bonuses and long-term incentive schemes to encourage and reward executive performance. It is recognized that the mix of rewards based on short-term and long-term indicators will vary between corporations and are established by the remuneration committee; however, the *Greenbury Report* does emphasize that bonuses are based on financial or operational measures that are "relevant, stretching and designed to enhance the business" (*The Greenbury Report*, 1995, p. 39). Similarly, the report recommends that long-term incentive schemes, including share option schemes, are payable only where stringent performance criteria are met, criteria that measure some aspect of the corporate's performance. Bonuses paid partly in the form of shares should be held for a minimum period of time, to create a long-term focus for the executives and to align their interests more closely with shareholders. A well-designed scheme should ensure that any "windfall gains" are aligned with actual improvements in corporate performance. Finally, the *Greenbury Report* highlights that performance targets need not be restricted to financial measures. They can include "operational" measures of performance, for example, quality or customer service. This recognition of nonfinancial performance measures enables remuneration committees to include sustainability targets such as reducing emissions in performance-based remuneration packages.

For non-executive directors, the *Greenbury Report* recommends fixed fees based on time required for the role. It also counsels against setting remuneration that is linked to performance. It is argued that a fixed fee structure is more likely to maintain independence. This indicates a stewardship view of the role of non-executive directors and contrasts with the stance taken in the

Greenbury Report for executive remuneration which is firmly set in an agency framework.

Service Contracts

The *Greenbury Report* recommends that director service contracts are on a 1-year basis, to avoid large termination payments due to early termination of 3- to 5-year contracts. Payments for contract termination are not to be included in employment contracts and, should be negotiated if the situation arises and reflect the reasons for the termination. Poor performance is not rewarded with a generous exit package, and compensation payments should be phased, rather than awarded as a lump-sum. These payments should cease when the director secures new employment.

Disclosure

To improve accountability and transparency on remuneration, the *Greenbury Report* requires full disclosure of information on all aspects of executive remuneration. The primary method of disclosure is the *Report of the Remuneration Committee* included in a company's annual report. The remuneration committee report will outline the corporate's general policy toward executive remuneration and provide detailed information on the actual remuneration packages of the individual executives and the breakdown per executive of the elements of the packages. The remuneration committee report should also outline the measures of performance used to determine rewards, how these relate to the long-term corporate objectives, and how rewards are linked to the measures themselves. In addition, details on the composition of the comparator groups and how they have performed are to be included.

To further align shareholder and executive interests, the *Greenbury Report* recommends that corporations seek a non-binding, advisory vote from shareholders on long-term incentive schemes. However, the *Greenbury Report* did not recommend a vote on the remuneration committee report or the full executive pay details.

Criticism of the Greenbury Report

The Confederation of British Industry, the Institute of Directors, and political opposition criticized the *Greenbury Report* and commented that it had not gone far enough in regulating business behavior (Jones and Pollitt 2002, p. 21). The main criticisms of the *Greenbury Report* are now outlined in brief.

It was claimed that a weakness underlying the *Greenbury Report* was that it was a reactive report, commissioned in response to public criticisms of remuneration packages enjoyed by executives in recently privatized utility corporations. Yet despite being commissioned in response to the behavior of executives in setting their own pay in utility corporations, interim reports did not address utility corporations, although this was rectified in the final report (Jones and Pollitt 2002).

It was argued that the *Greenbury Report* promoted a tick-box approach to good governance and executive remuneration. It enabled corporations, considered to have "excessive" executive compensation packages, to claim best practice by complying with the recommendations in the *Greenbury Report*. For example, British Gas, one of the corporations whose behavior led to the commissioning of the report, claimed it was at the leading edge of best practice simply because it disclosed its policies (Jones and Pollitt 2002, p. 21)!

Weaknesses were also documented in respect of its recommendations. The focus on the "knowledge of the corporation" as the basis for excluding external members from the remuneration committee implicitly excludes newly appointed directors, yet newly appointed directors are arguably the most independent. Thus, there is an implicit trade-off between director independence and knowledge of the corporation. This conflict could have been eliminated had the *Greenbury Report* recommended that the remuneration committee seek counsel from external expert advisors and external consultants. New directors would not be eliminated from being members of the remuneration committee as they could gain advice from these experts when required. The inclusion of external remuneration advisors was later recognized in the revised Combined Code 2003, and the use of external experts is now a common practice. There is no guidance on how remuneration committees can deal with potential challenges and conflicts in the *Greenbury Report*.

It was argued that the *Greenbury Report* and working group were self-serving, consisting mostly of executives who benefitted from the status quo and were unlikely to recommend any radical new proposals (Jones and Pollitt 2002; Price 2016). The Group lacked representation from and engagement with other stakeholders, such as small shareholders, employees, customers, and the media whose voices led to the creation of the Group (Jones and Pollitt 2002, pp. 19–20). For example, the *Greenbury Report* required that the remuneration committee have an "understanding of shareholder concerns"; however, shareholders had limited involvement with the working group that was established to review executive remuneration, and specific procedures for gaining an understanding of shareholder concerns were not included. The Group defended their decision not to include measures such as "say-on-pay" in the *Greenbury Report* as shareholders already had opportunities to raise their concerns at corporate annual general meetings (*The Greenbury Report*, 1995, pp. 32–33). However, the Group failed to consider the rights of small shareholders whom had demonstrated outside the British Gas annual general meeting as they did not feel listened to by the board or by the large institutional shareholders. This failure to consider shareholder views on executive pay was tackled by legislators in 2002, when UK corporate law introduced a requirement that corporates conduct an advisory "say-on-pay" at the annual general meeting (Petrin 2015).

It was argued that the publication of pay and benchmarking remuneration policy against comparator corporates could have had an inflationary effect on executive pay (Hughes 1996). With respect to benchmarking, there was limited guidance on what corporates should be included in the comparator group, leaving it open to manipulation by unscrupulous executives.

There were no financial incentives provided in the *Greenbury Report* for non-executive directors, yet non-executive directors would comprise the remuneration committee and set the remuneration policy. Further, it was noted that the recommendation for flat fees for non-executive roles was not supported by evidence (Hahn 2006; Hahn and Lasfer 2010). Indeed, it was claimed that flat fees could have negative consequences as they could relieve non-executives from the burden of responsibility for financial loss as a result of their errors. Moreover, Hahn (2007) reported no association between attendance at meetings and non-executive director fees and concluded that flat fees do not encourage effort.

Despite these weaknesses, there was a significant improvement in the quality and quantity of disclosures relating to directors and executive remuneration following the *Greenbury Report*. However, it is claimed that the increased disclosure and transparency did not translate into the desired results, as remuneration disclosure often lacked clarity on the relationship between performance and rewards (Petrin 2015). In addition, most remuneration committees were not independent, and few corporations gave their shareholders a vote on pay, despite shareholder concerns about executive compensation (Petrin 2015).

Summary

Prior to the *Greenbury Report*, the absence of reporting requirements on remuneration committees resulted in opaque remuneration decisions that were difficult to challenge. The *Greenbury Report* and subsequent measures, that target the pay-setting process, have demonstrated that governance can improve the regulation of executive pay. In addition, it is claimed that the links between pay and performance have improved (Petrin 2015; Ndzi 2016). The *Greenbury Report* also introduced the option of nonfinancial performance measures which most corporations now include in the determination of executive pay. Indeed, several studies have found an increasing use of sustainability targets in executive incentive schemes (Abdelmotaal and Abdel-Kader 2016;

Clarke 2013; Labini et al. 2019). Thus, investors can identify corporates committed to the long-term interests of shareholders and society by assessing their remuneration polices.

However, despite the improvements in transparency and accountability, the 2008 global financial crisis revealed it was still possible for executives to receive immense salaries and bonuses while running up toxic debts and unsustainable levels of risk in the corporations they governed. Thus, shareholders continued to be exposed to unacceptable levels of risk associated with excessive executive pay. Moreover, it is now evident that corporate failure does not only impact on shareholder wealth. The economic fallout in the aftermath of the financial crisis verified how important the financial industry and corporate success is to society at large.

The principle established in the *Greenbury Report*, that corporate boards are best suited to determine their directors' remuneration, still stands. However, leaving executive pay to boards, the continued existence of gray areas and a lack of enforcement procedures tends to lead to ever-increasing executive pay and the associated risks not only to shareholders but to society.

Cross-References

- ▶ Agency Theory
- ▶ Combined Code (2010)
- ▶ Corporate Activism
- ▶ Corporate Governance Compliance
- ▶ Executive Remuneration and CSR
- ▶ Governance
- ▶ Higgs Review
- ▶ Social Justice
- ▶ Stakeholder
- ▶ Stakeholder Theory
- ▶ Walker Review (2009)

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